No. 286

# Supreme Court of the United States

OCTOBER TERM, 1961

UNITED STATES, PETITIONER,

*versus*

TALBOT PATRICK, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

## BRIEF FOR TALBOT PATRICK, ET AL.

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## CITATIONS

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### QUESTIONS PRESENTED

1. Whether the portion of a taxpayer-husband's legal expenses, allocable to the property settlement aspect of a divorce proceeding, are deductible, for income tax purposes, on the theory that they are "ordinary and necessary expenses paid * * * for the management, conservation, or maintenance of property held for the production of income," within the meaning of Section 212 (2) of the Internal Revenue Code of 1954.

2. Whether the taxpayer-husband, having been ordered by the state court to pay, and having paid, legal fees owed by the wife to her attorney for similar services, may deduct those fees under Section 212 (2) of the 1954 Code.

## STATEMENT

Taxpayer does not accept the statement of the case by the United States as it is not a fair statement and contains, at least one gross error significant to a portion of the Petitioner's argument.

Talbot Patrick, the taxpayer, was sued for divorce by his then wife, Paula M. Patrick, on December 16, 1955, in the Court of Common Pleas for York County, South Carolina. The wife sought an absolute divorce on grounds of adultery, court supervision of division of the properties, a property settlement, child custody, and attorneys fees. Taxpayer neither admitted nor denied the allegations of adultery and did not offer testimony at the divorce hearing. The Court subsequently issued a final decree of absolute divorce, approved the property settlements made by the parties in an "Amended Stipulation and Agreement", and, by reference, required the payment by taxpayer of all attorney fees. (P.R. 7, 46-47.)[1]

The "Amended Stipulation and Agreement" was the result of extended negotiations between counsel for both parties. It provided for payments by the taxpayer for the support and maintenance of the parties' children (P. R. 9-11) and contained provisions relating to specific properties. The taxpayer and his wife were each to receive one of the two family residences. (P. R. 8) Income producing properties then were considered. Taxpayer purchased at fair market value, the rights to income from and voting control of his wife's 28% of stock in Herald Publishing Company under a provision that he could not sell the stock unless it was part of a sale of the whole of the company's stock and that then the stock must first be transferred to his children who would affect the sale and receive the proceeds. In the event of his prior death the stock would pass

[1] References to the record in *United States v. Patrick*, No. 256, are prefixed "P. R."

to his children. (P. R. 5, 11-12.) Taxpayer's 80% interest in real property leased in part to the publishing company was placed in trust with the net income to the wife for life and then to the children; with the trust to terminate when the youngest child reached the age of 21 years, at which time the property would be conveyed to the children. (P. R. 5, 8-10.) A part of the agreement provided continued use of the property by the publishing company under a lease for ten years (with options for renewal).

Taxpayer, who was editor and publisher of the company's newspaper, was a minority stockholder in the corporation, the majority of the stock being in the wife (28%) and in trusts for the children (35%) and in a son (9%). (P. R. 4.)

The attorneys' fees incurred by each party were $12,000.00, a total of $24,000.00. Pursuant to the divorce decree the taxpayer paid these fees. Fees were allocated by counsel and the parties as follows: $4,000.00 for the handling of the divorce, $4,000.00 for the handling of the real estate ($3,200.00 charged to taxpayer and $800.00 to his wife in proportion to prior 80% and 20% interests), and $16,000.00 for negotiation and rearrangement of the stock holdings.

Taxpayer claimed deductions for the $16,000.00 paid for legal services in connection with the stock and $3,200.00 for services in connection with the real estate. He did not claim any part of the $4,000.00 paid for legal services connected with the divorce. (P. R. 46-52.)

The District Court found that the $3,200.00 and the $16,000.00 paid by Talbot Patrick as attorneys fees were deductible as expenses incurred for the management, conservation or maintenance of property held for the production of income. The Court of Appeals affirmed, saying that in view of the findings of fact of the District Court and the undisputed testimony in behalf of the petitioner, the legal

fees in the amount of $19,200.00 which were paid by taxpayer for the protection and conservation of his income-producing property was properly deductible as claimed.

## SUMMARY OF ARGUMENT

### I

Legal expenses which are reasonably and proximately related to the management, conservation, or maintenance of property held for income are deductible for income tax purposes. In this case the trier of the facts, the District Court sitting without a jury, determined as a matter of fact that the expenses in question were reasonably and proximately related to the management, conservation, or maintenance of income-producing property. The fees paid in connection with the dissolution of the marriage relationship were properly considered by the taxpayer to be personal, and these were not claimed. But fees expended by a minority stockholder to retain threatened control of a business which he had held by sufference only and to be able to continue the uninterrupted use of a business leasehold when he had divested himself of any ownership of the property cannot be considered personal. The government seeks too broad a rule: It may be true that fees incident to a divorce may in some cases not be deductible as personal expenditures too remote from income or income-producing property. But under the decided facts in this case the fees were properly deductible.

And the fees were no part of the capital cost of acquisition of property since taxpayer paid market value for stock but gained only the limited control and use of the stock. The fees were involved in the lengthy negotiations necessary to find an acceptable means of rearranging property holdings.

II

If attorneys fees are in truth deductible, they are deductible to the person who pays them under a legal duty to do so regardless to whom they are paid. Since the divorce fees themselves were separated and not claimed, the fees claimed as deductible were all expended for the same purpose and in much the same manner as if there had been involved the dissolution of a business partnership.

## ARGUMENT

I

Since 1942 there has been provision in the Internal Revenue Code for deduction of some nonbusiness expenses. This was the Congress' solution to the problem of lack of such legislation as emphasized by the case of *Higgins v. Commissioner*, 312 U. S. 212. An examination of the statute and the decided cases makes clear that whether or not an expense is in connection with the taxpayer's trade or business, if it is expended in the pursuit of income or in connection with property held for the production of income, it is allowable. This does not apply to expenses primarily involved in sports, hobbies, or recreation, but does apply when such expenses are ordinary and necessary, reasonable in amount, and bear some reasonable and proximate relation to the production or collection of income or to the management, conservation, or maintenance of property held for that purpose. Thus on a showing that in this case the attorneys' fees taxpayer was required to pay met these tests, the District Court properly held them deductible. In this case the United States has not questioned that the fees were ordinary and necessary expenses and reasonable in amount. The issue grows out of the activity to which the fees were related.

A. The trier of fact has determined that attorneys fees here involved bore a reasonable and proximate relation to the management, conservation, or maintenance of property held for income.

In this case the District Court, sitting without a jury, heard all the facts and circumstances and determined that the attorneys fees were expended by taxpayer in the management, conservation, or maintenance of income-producing property.

In *Trust of Bingham v. Commissioner*, 325 U. S. 365, the Tax Court had heard the facts and concluded that legal fees were expended for the management and conservation of income-producing property. The Second Circuit reversed, 145 F. (2d) 568. The Supreme Court granted certiorari; and, in reversing the Second Circuit and affirming the findings of the Tax Court, said:

> "* * * Deductible expenses * * * must be reasonable in amount and must bear a reasonable and proximate relation to the management of property held for the production of income. * * * Ordinarily, questions of reasonableness and proximity are for the trier of fact, here the Tax Court. *Commissioner v. Heininger*, 320 U. S. 467, *McDonald v. Commissioner*, 323 U. S. 57, 64-65, *Commissioner v. Scottish American Investment Co.*, 323 U. S. 119. * * * The Tax Court could find as a matter of fact, as it did, that the expenses of contesting the income taxes were a proximate result of the holding of the property for income. And we cannot say, as a matter of law, that such expenses of suits to recover income."

B. Attorneys fees reasonably and proximately related to the management, conservation, or maintenance of property held for the production of income are not personal, living, or family expenses, but are nonbusiness expenses properly deductible under Code Section 212 (2).

In *Lykes v. United States*, 343 F. S. 118, the Court reviewed the whole question of nonbusiness deductions. It cited in particular the House Committee Report:

> "* * * Thus, whether or not the expense is in connection with the taxpayer's trade or business, if it is expended in the pursuit of income or in connection with property held for the production of income, it is allowable * * *. The expenses, however, of carrying on a transaction * * * primarily as a sport, hobby, or recreation, are not allowable as non-trade or non-business expenses. Expenses to be deductible * * * must be ordinary and necessary, which rule presupposes that they must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of income or to the management, conservation, or maintenance of property held for that purpose * * *." H. R. Rep.

2333, 77th Congress, 2nd Session. To the same effect see S. Rep. No. 1631, 77th Congress, 2nd Session.

In *Lykes*, the ordinary and necessary character of the legal expenses incurred was recognized. Deductibility turned wholly upon the nature of the activities to which they related. And so, as taxpayer sees it, does this case.

*Lykes* considered a gift tax question. The taxpayer gave away stock with a fixed value and the Commissioner of Internal Revenue revalued it and assessed a deficiency. The fees in that case were incurred in contesting this deficiency or in resisting liability, not as in the instant case, in seeking and finding a legal and acceptable manner for rearranging holdings of income-producing property to meet a liability and still conserve income and income-producing property.

"Legal expenses", said *Lykes*, "do not become deductible merely because they are paid for services which relieve a taxpayer of liability * * *. (The) Section never has been so interpreted by us. It has been applied to expenses on the

basis of their immediate purposes rather than upon the basis of the remote contributions they might make to the conservation of a taxpayer's income-producing assets by reducing his general liabilities." *McDonald v. Commissioner*, 323 U. S. 57, 61-63.

In *Lukes* the taxpayer was resisting a deficiency tax assessment and seeking to reduce a cash liability. The Court was faced with these facts and also with Treasury Decision 5513, 23 CFR 29.23 (a)-15 (k) in force since 1946 (to which it gave weight) unequivocally holding that fees in determining gift tax liability are not deductible.

In *Baer v. Commissioner*, 196 F. (2d) 646, the Eighth Circuit Court of Appeals held that "* * * the controversy did not go to the question of liability but to the manner in which it might be met by the petitioner without greatly disturbing his financial structure * * *" The Court allowed $16,500.00 of the husband's attorneys fees as being involved in the maintenance or conservation of property for the production of income.

Fees similarly were allowed on this basis in *Fisher v. United States*, 157 Fed. Supp. 364, and *Aller v. United States*, 56-2 USTC 9867.

In *Bowers v. Commissioner*, 243 F. (2d) 904 (6th C. A.) the Court allowed a $45,000.00 attorneys fees as claimed, with the statement that as in the *Baer case* there was little occasion for lawyer's services in the divorce, that their services were largely devoted to adjustment of the taxpayer's liability to his wife.

In *McMurtry v. United States*, 132 Fed. Supp. 414, the Court of Claims cited *Baer* and gave taxpayer an opportunity to show to what extent legal expenses were incurred in conservation and maintenance of property.

In certain cases attorneys fees have been denied. But they are easily distinguished from the instant case.

In *Harris v. United States*, 275 F. (2d) 238, the Ninth Circuit held that attorneys' fees were incurred to resist the wife's claim that there was community property and there was no evidence of the value of the attorneys' fees in dividing property. This case, the Court said, was not *Bacr*.

In *Tressler v. Commissioner*, 228 F. (2d) 356, the Ninth Circuit cited *Bacr* and *McMurtry* but distinguished *Tressler* by saying that the expense of the litigation was incurred to defeat the wife's suit and not to protect the petitioner's property.

In *Howard v. Commissioner*, 202 F. (2d) 28, the Ninth Circuit cites *Bacr* with approval but says that Howard's fees involved the defense of the wife's action to collect money awarded her in a divorce action and therefore were not deductible. *Smith's Estate v. Commissioner*, 208 F. (2d) 349, and *Norton v. Commissioner*, 192 F. (2d) 960, can be similary distinguished.

In refusing to permit deductions, the Fourth Circuit has said in *Richardson v. Commissioner*, 234 F. (2d) 248, that "* * * It is clear that the attorneys for the husband expended no effort in the conservation or maintenance of his property as envisioned by the statute * * * Their services were directed to preventing any liability being imposed upon the husband for the wife's support and it is this for which they were paid. * * * Even if any part of the fee paid by him to his attorneys could be said to be for services in conserving his property, no effort has been made to show what part of the sums paid should be alloted to that purpose * * * Unless and until it is shown what part of the sums paid them are applicable to that part of their efforts there is no basis upon which to grant a deduction * * * None of the conditions which formed the basis for the decision in the *Bacr* case exists in the case now before us."

In *Douglas v. Commissioner*, 33 T. C. 349, the wife was attempting to deduct legal fees incurred in an attempt to secure property in connection with a marital separation.

*Donnelley v. Commissioner*, 16 T. C. 1196, disallowed deduction of legal expenses paid in resisting a former wife's suit to collect back alimony. This case was decided before the *Baer case*.

In *Lewis v. Commissioner*, 253 F. (2d) 821, the Second Circuit refused to allow attorneys fees on the theory that such fees were spent in resisting legal separation proceedings and liability. The case was in no way similar to the instant case.

Judge Waterman did write in *Lewis, supra*, that he could not reconcile *Baer* with *Lukes*; but Judge Lumbard "would limit this discussion to distinguishing *Baer v. Commissioner* on its facts" and he would have allowed expenses in litigation over revocation of an *inter vivos* trust.

All decisions read with the statute and *Lukes* in mind simply bear out that not all attorneys fees are deductible but equally that in certain circumstances they are. A broad rule such as is sought here would bar relief in proper cases such as the instant one.

The courts have allowed deduction of attorneys fees in property settlements growing out of divorces where there is a reasonable and proximate relation to production of income or conservation or management of income property.

> An essential in this case, as in the *Baer* line of decisions and as outlined in the *Lukes case*, was that the fees were not expended to resist liability but to find a manner in which it could be met without depriving taxpayer of his income or income-producing property.

Consideration should be given to the question as to whether or not a "treat" to property is the real test in the *Baer* line of cases. It is true that a "threat" appears, but that was

the occasion for the expenditures of fees rather than the justification therefor under the law.

In any event, there was a "threat" to both the income and the income producing property of taxpayer in this case. (P. R. 31.)

At the time he was sued for divorce, taxpayer was a minority stockholder in *Herald Publishing Co.* He owned 28%, his wife 28%, a son Hugh 9%, with 7% additional in trust, and two other children owned 28% of the stock in trust. Because of the family unity which had existed, taxpayer had controlled the Herald operations and had been Editor and Publisher of the newspaper and a director and president of the corporation and drew salaries therefrom. With the commencement of the suit against him, practically everything he had was at risk. There was the distinct possibility that control of the corporation would be sold, and the wife's attorneys were approached by prospective purchasers.

It was not necessary for his wife to take from him his Herald stock for taxpayer to be subject to the loss of his salaried position and his only salary income as well as control of the operations to which he had given years of effort and which he had built up. His wife, with her 28% of the stock and as trustee jointly controlling the stock of her children and with the support of her son Hugh's, could have controlled the corporation. With family unity broken, this control could have been exercised by the wife to taxpayer's detriment.

It developed in the negotiations, however, that there was a way to meet taxpayer's liabilities to his wife.

He did not resist these liabilities, and attorneys fees were not expended for that purpose.

The negotiations concerned themselves with the manner in which taxpayer could meet these liabilities without

destroying his income and income property status. These were the immediate purposes of the expenditure of the fees. The United States argues that the agreement between the parties as to the manner of solution shows full accord and harmony between the parties and no risk to taxpayer. In so arguing, Petitioner is ignoring a fact of life; that months of patient negotiation by competent and experienced counsel concerned with the best interests of their clients was necessary to effect the agreement.

The risk and danger to income and income producing property was there until the matter was concluded. And it was not concluded until there was a readjustment of income-producing holdings under which the taxpayer gave up his undivided interest in the building occupied by the newspaper and thus assured that there would be no partition of this real estate or outside co-owner and no interruption of occupancy of the building, conserving also its income-producing potential for the children of taxpayer and his wife. Prior to this agreement, the wife had equal rights to control or block control of the use of this business real estate. (R. 32, 33.)

The matter was not concluded until taxpayer had transferred some $112,000.00 in high quality income-producing stocks and bonds in exchange for what amounted to a voting right for life in the wife's stock in the newspaper corporation. The manner of meeting taxpayer's liability in this particular was important in preserving his financial structure. It is implied that there was no overt move to claim taxpayer's stock and that anything else of value would have satisfied the wife's claim and that stocks and bonds did in fact satisfy this claim without disturbing taxpayer's Herald stock. But Mr. Spencer testified that he was convinced that Mrs. Patrick had a definite and special interest in the Herald Publishing Co. stock as such, for-

reasons shown, and would not in any sense have considered some other blue chip stock of equal monetary value to be acceptable by way of direct exchange with no limitations. (P. R. 37.)

So, for all purposes, Patrick was in the position of *Bacr*. To try to define degrees of threat or to be guided by total sums of money involved would lead the Court too far astray from what seems to be a sound construction of the basic statute in the light of the legislative intent.

Examination also reflects that an essential element outlined in *Lakes* and considered in *Bacr* and related cases is that the controversy did not go to the question of liability but to the manner in which it might be met without disturbing taxpayer's financial structure.

C. Attorneys fees were not the cost of acquiring stock or disposing of real estate but were reasonably and proximately related to management, conservation, and maintenance of income-producing property.

Fees were expended, as argued above, for the negotiations which produced a settlement determining a manner for meeting the wife's claims without disrupting taxpayer's ability to earn. (P. R. 40, 41.)

Taxpayer's salary, as he testified (Tr. 38), was low because of his interest in the newspaper and the building of a good property. It was necessary to his continued income and protection of the value of his income-producing stock that he continue his control. So, the shifting of other income-producing property for that which would assure him a voting control of the corporation and continuance of his positions with the corporation was necessary. These were incidents of management and conservation of his income-producing property; and this was a part of the expense incurred by him. And his income situation was changed by the settlement, so that the newspaper position and prop-

erty became more important in his total financial situation. He paid from income producing property the fair market value of his wife's stock, but obtained only control, the stock to pass to his children prior to any sale or to them at his death. And he lost the income from rental of the business property which had made up a part of his total income.

His placing of his undivided interest in the business real estate in trust along with the undivided interest therein of his wife was an incident of the management and conservation of his income-producing property through protection against division and through assurance of an undisturbed lease for the newspaper. And this, too, was the result of negotiations by counsel for which the fees were paid.

## II

Legal fees which taxpayer was required to pay his wife's attorneys were deductible exactly as were those he paid his own attorneys.

Attorneys fees were demanded in the divorce action and required to be paid by taxpayer under the Court's final Order. So far as they related to the divorce itself and the essentials thereof $2,000.00 to his own and $2,000.00 to his wife's attorneys) they were paid by taxpayer and not claimed as deductible. But $19,200.00 in fees paid jointly to the attorneys for taxpayer and his wife and attributed to the long negotiations of and rearrangement of the stock and business property were paid and are claimed as deductible. If the fees were in truth deductible because of the activities to which they related, as argued herein, they were deductible to taxpayer no matter to whom the taxpayer paid them.

In *Owens' v. Commissioner*, 273 F. (2d) 251, the Fifth Circuit permitted deduction of fees paid to the wife's attorney in a property settlement incident to a divorce. The

Court set out, as is argued here, that "* * * deductibility turns wholly upon the nature of the activities to which they related * * * We do not think that the fact that the payment was made to the wife's attorney has any determinant force * * * The ultimate and only fact before the Tax Court and before us was and is whether the $7,500.00 was actually paid to the attorney in connection with the saving of the business in which the husband was interested * * *. In other words, the domestic dispute furnished the occasion, but not the motive, for the payment of the $7,500.00 to the attorney."

From the Patrick record it appears that much of the negotiations of attorneys in connection with the property settlement was designed to arrive at a means of permitting taxpayer to retain his control of the newspaper and his offices and employment but to "tie up" and limit his interests in a manner acceptable to his wife. And in this area it appears that there were "almost joint aims" of opposing counsel (although certainly within every bound of propriety).

John H. Lumpkin, counsel for the wife, testified that "I am trying to recollect as precisely as possible, which is the reason for my pause, the background and the reasons for the final stipulation. Certainly in part it was as stated by you, to tie up his interest thereby protecting the children. Certainly in part it was to continue him in active management of the newspaper and to provide that if he should dispose of could dispose of his interest, the children would be protected, and finally I think a very cogent reason in these negotiations as culminated in the Stipulation was to continue him in an income producing status."

He was asked: "Mr. Lumpkin, are you speaking of the negotiations as a whole, or the aims which you were striving for as Mrs. Patrick's attorney?" and he replied:

"I might say these are almost joint aims as between Mr. Spencer as attorney for the Defendant and by me as Attorney for the Plaintiff."

It is true the Eighth Circuit did not allow the wife's attorneys fees in *Baer*. But in *Baer* it was argued that $35,000.00 for purchase of a home and $20,000.00 attorneys fees were "periodic payments" to the wife when all the evidence showed this as a lump sum part of a divorce settlement. There was no claim or inding of fact that the fees were related to the conservation of income producing property. The present (*Patrick*) case makes no attempt to deduct the elements of the settlement on taxpayer's wife nor does it claim that the attorneys fees were part of "periodic payments" to her. It poses the question as coming within the thinking of the *Lykes case*: that the fees were reasonably and proximately related to the management, conservation and maintenance of income producing property.

In *Norton*, *Richardson*, and *Lewis*, all examined herein above, the wife's attorneys fees were not allowed; but the question here posed was not answered there since none of the fees were allowed. It would follow that if the attorneys fees, because of the activities to which they related, were not deductible as to the husband's attorneys, they would not be deductible by him as to the wife's attorneys.

The only test under the Statute is that the fees be expended in a transaction reasonably and proximately related to the production or collection of income or the conservation, management, or maintenance of income-producing property. If they were so expended, then they are deductible no matter to whom they were paid.

## CONCLUSION

The judgment of the Courts below should be affirmed.

Respectfully submitted.

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Rock Hill, South Carolina,
February, 1962.